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In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN STUART

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Seventh Circuit entered in the above case on December 19, 1941, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 27–32) is unreported. The opinion of the Circuit Court of Appeals (R. 38–49) is not yet officially reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 19, 1941 (R. 49). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer executed three trusts, one for each of his three children, naming himself, his wife, and his brother as trustees. The trustees had complete dominion over the trust property, which consisted of shares of stock in a corporation of which the taxpayer was president and his brother was first vice president; in addition, the taxpayer retained substantial control over the corpus which he could exercise without the concurrence of the other two trustees. The beneficiary of each trust was to receive for fifteen years so much of the net income as the trustees in their sole discretion deemed advisable, the balance to be added to corpus. After the expiration of fifteen years the net income was to be paid to the child-beneficiary for life. During the life of the taxpayer, his wife and brother had power to "alter, change, or amend" the trusts "by changing the beneficiary * * * or in any other respect." Was the income from the trusts taxable to the grantor under Sections 166 (2), 167 (a), or 22 (a) of the Revenue Act of 1934?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Apendix, *infra*, pp. 12–20.

STATEMENT

The facts, as stipulated (R. 12–20), and as found by the Board of Tax Appeals (R. 27–30), may be stated as follows:

The taxpayer in 1930 established three trusts in substantially identical terms, one for each of his three children.[1] He was president of the Quaker Oats Company and the corpus of each trust consisted of 700 shares of stock of that corporation (R. 27). At the time the trusts were created his net worth was in excess of $4,000,000, and the securities placed in trust had a value of approximately $575,000 (R. 30).

The taxpayer named himself, his wife, and his brother[2] as the trustees of each trust (R. 27). The trustees were given broad powers of management (R. 28), and each trust contained an exculpatory clause relieving the trustees of liability except for "actual fraud or willful mismanagement" (R. 28–

[1] During the years involved, 1934 and 1935, the children were adult (R. 27).

[2] The brother, Robert Douglas Stuart, was also the grantor of four similar trusts, one for each of his four children, and his liability for tax with respect to the income therefrom is involved in a companion case which was disposed of by the court below together with this case in a single opinion. Robert Douglas Stuart was vice president of the Quaker Oats Company.

29). In addition, the taxpayer reserved the right to himself to direct the sale of the corpus and reinvestment of the proceeds, as well as the right to withdraw and take over the corpus upon substituting other property of an equal market value. (See Paragraph "Eighth", R. 29.)

Each trust provided that for a period of fifteen years the trustees were to pay over to the child designated as beneficiary, "so much of the net income from the Trust Fund as they in their sole discretion shall deem advisable," and to add the undistributed income to corpus (R. 27–28). After the fifteen-year period, the trustees were to pay the entire net income to the beneficiary for life, and upon death of the beneficiary, to pay over the principal to the beneficiary's surviving issue, with remainders over in the event of default.

Two of the trustees, the taxpayer's wife and his brother, were given sweeping powers to alter, change, or amend the trust, including the power to change the beneficiary. In that respect, paragraph "Ninth" of each trust provided as follows (R. 29):

> Ninth. During the life of the Donor, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, or the survivor of them, shall have full power and authority, by an instrument in writing signed and delivered by them or by the survivor of them to the Trustees, to alter, change or amend this Indenture at any time and from time to time by changing the beneficiary hereunder,

> or by changing the time when the Trust Fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, or in any other respect.

On August 3, 1935, the taxpayer's wife and brother executed an amendment to each of the three trusts cancelling paragraph "Eighth" (dealing with the taxpayer's right to withdraw corpus, etc.) and changing paragraph "Ninth" to read as follows (R. 29):

> Ninth. This Indenture and all of the provisions thereof are irrevocable and not subject to alteration, change or amendment.

The taxpayer's brother had similarly created like trusts (see footnote 2, *supra*) for his own children, naming himself, his wife and the taxpayer as trustees, with like powers of alteration vested in the latter two trustees. And at about the same time in August 1935, the taxpayer and his brother's wife, made similar changes in his brother's trusts eliminating the power of further alteration therein.

The question in this case is whether trust income for the year 1934 and that portion of 1935 prior to the foregoing modification may be charged to the donor for income-tax purposes. The Board of Tax Appeals sustained the tax. The court below reversed, rejecting the Government's contentions that the income was taxable to the donor, (1) under Section 166 (2) or Section 167 (a) of the

Revenue Act of 1934 in view of the power of the other two trustees to revoke the trust or to deflect the income to him; (2) under Section 22 (a) in view of the taxpayer's continued control over the corpus amounting to substantial ownership.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the income from the trusts was not taxable to the taxpayer under Section 166 of the Revenue Act of 1934.

(2) In holding that the income from the trusts was not taxable to the taxpayer under Section 167 of the Revenue Act of 1934.

(3) In holding that the income from the trusts was not taxable to the taxpayer under Section 22 (a) of the Revenue Act of 1934.

REASONS FOR GRANTING THE WRIT

1. Under paragraph "Ninth" of each trust indenture respondent's brother and wife had full authority to "alter, change, or amend" the trust "by changing the beneficiary hereunder * * * or in any other respect." The income therefrom was therefore taxable to the donor under the unambiguous provisions of Sections 166 (2) and 167 (a), and the decision of the court below defeats the very objective at which those provisions were aimed. Prior to the Revenue Act of 1932 the literal terms of Section 166 provided for the taxation of the income of a trust to a grantor only

where he had retained some power either alone or in conjunction with some other person (not adversely interested) to revest the corpus in himself. The language of the statute was changed in the 1932 Act expressly in order to include the situation where the grantor did not share in the power [3] and as so changed was carried over into the Revenue Act of 1934, the statute involved herein.

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[3] S. Rep. No. 665, 72d Cong., 1st Sess., p. 34 (1939–1 Cum. Bull. (Part 2) 496); with respect to the bill that became the Revenue Act of 1932 contains the following language:

"Under the present law the income of a trust is taxable to the grantor where, at any time during the taxable year, the grantor has power to revest in himself title to any part of the corpus of the trust, either alone or in conjunction with any person not a beneficiary of the trust. In an attempt to avoid this section, the practice has been adopted by some grantors of reserving power to revest title to the trust corpus in conjunction with a beneficiary having a very minor interest or of conferring the power to revest upon a person other than a beneficiary; in such cases the grantor has substantially the same control as if he alone had power to revoke the trust. While it is, of course, yet to be established that such device accomplishes its purpose, it is considered expedient to make it clear that in any of these cases the income shall be taxed to the grantor. The House bill made the grantor of a trust taxable upon the income of any part of the corpus of the trust, where the power to revest in the grantor title to such part of the corpus was in the grantor alone or was in the grantor in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus. *Your committee has extended the scope of this provision so as to include, as well, the cases where the power to revest title to any part of the corpus is held, either alone* or in conjunction with the grantor, by a person not having a substantial adverse interest in such part of the corpus or in the income therefrom." [Italics supplied.]

In failing to give effect to the provisions of Section 166 (2), the decision below is in conflict with *Fulham* v. *Commissioner*, 110 F. (2d) 916 (C. C. A. 1st); and in failing to give effect to the provisions of Section 167 (a), the decision is in conflict with *Altmaier* v. *Commissioner*, 116 F. (2d) 162 (C. C. A. 6th), certiorari denied, 312 U. S. 706; *Rollins* v. *Helvering*, 92 F. (2d) 390 (C. C. A. 8th), certiorari denied, 302 U. S. 763; *White* v. *Higgins*, 116 F. (2d) 312 (C. C. A. 1st); and *Kent* v. *Rothensies*, 120 F. (2d) 476 (C. C. A. 3d), certiorari denied, October 13, 1941, No. 537, present Term.[4]

The suggestion of the court below that Sections 166 and 167 are inapplicable because the trustees had a substantial adverse interest is without foundation. The trustees did not have any "substantial adverse interest" in the trusts; they were not beneficiaries and to the extent that they could exercise the power to substitute themselves as bene-

[4] The intimation of the court below that the provisions of Section 166 (2) and Section 167 (a) are inapplicable here since the brother and wife, under Illinois law, had to exercise their discretion as to change of beneficiary, etc., with due regard to their fiduciary duties is in the teeth of *Reinecke* v. *Smith*, 289 U. S. 172, 176–177. There, the identical argument was made with respect to a trust also controlled by Illinois law, and the taxpayer has not relied upon any Illinois cases here that were decided after *Reinecke* v. *Smith*. And in holding that the existence of fiduciary duties under state law forbids the imposition of the tax, the decision below is contrary to *Fulham* v. *Commissioner*, *supra*; *White* v. *Higgins*, *supra*; *Cox* v. *Commissioner*, 110 F. (2d) 934 (C. C. A. 10th), certiorari denied, 311 U. S. 667.

ficiaries, the taxpayer could similarly participate in the exercise of like powers with respect to the like trusts established by his brother. In these circumstances, and in the light of the business and family relationships, the Board's determination that the trustees did not have a substantial adverse interest finds ample support in the record. Moreover, the very purpose of these provisions in Sections 166 (2) and 167 (a) was to reach cases where the grantor would place the power of amendment or revocation in the hands of persons who would normally be responsive to his desires, and persons most likely to fall in that category are members of his immediate family. To the extent that the decision below reaches a different result it is in conflict with *Altmaier* v. *Commissioner*, 116 F. (2d) 162 (C. C. A. 6th), certiorari denied, 312 U. S. 706; *Fulham* v. *Commissioner*, 110 F. (2d) 916 (C. C. A. 1st); *Loeb* v. *Commissioner*, 113 F. (2d) 664 (C. C. A. 2d); and *Commissioner* v. *Casperson*, 119 F. (2d) 94 (C. C. A. 3d), certiorari denied, October 13, 1941, No. 220, present Term.

2. The decision below is also in substantial conflict with *Commissioner* v. *Buck*, 120 F. (2d) 775 (C. C. A. 2d), and *Commissioner* v. *Brown*, 122 F. (2d) 800 (C. C. A. 3d), with respect to the application of the principles established by *Helvering* v. *Clifford*, 309 U. S. 331. The conflict on this point is present even upon the assumption that no

change could have been made in the trusts herein which would have diverted any part of the corpus or income to the grantor.

In the *Buck* case the trust was unlimited as to term; the named beneficiaries were the grantor's wife and children, and his reserved power to change the beneficiaries was limited so that he could not divert any part of the income or corpus to himself; he retained the powers to remove the trustee, to direct the trustee in the retention, disposition, and investment of the corpus, and to vote any stock or to direct the trustee how to vote it. The Second Circuit held the doctrine of the *Clifford* case applicable and the income taxable to the grantor under Section 22 (a).

The *Brown* case was essentially similar to the *Buck* case. It presented a somewhat stronger case for the taxpayer in that the powers of management could be exercised only indirectly by the substitution of trustees, and the named beneficiaries were not related to the grantor. The Third Circuit followed the decision in the *Buck* case and held Section 22 (a) applicable.

The instant case presents a comparable picture. The named beneficiaries were subject to change by persons whom the Board has found would be amenable to the taxpayer's wishes. Certainly in view of the broad powers of management vested in the taxpayer alone as grantor by Article Eighth of the indentures (R. 17–18) and in him as one

of the trustees by Articles Second and Tenth (R. 15, 18), the court below erred in stating that there was no power of management in the grantor. It is also significant that the corpus of each trust consisted of shares of stock in the Quaker Oats Company, of which the taxpayer was president. By Article Eighth of the indentures he reserved sufficient power to reacquire that stock and vote it as he chose, in the remote event of any disagreement between himself and the other trustees. There is a substantial conflict therefore between the instant case and the *Buck* and *Brown* cases.

CONCLUSION

The decision below conflicts with decisions in other circuits in several vital respects upon questions of public importance in the administration of the Revenue Acts. It is therefore respectfully submitted that the petition be granted.

CHARLES FAHY,
Solicitor General.

MARCH 1942.

APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal services, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * *

(U. S. C., Title 26, Sec. 22.)

SEC. 166. REVOCABLE TRUSTS.

Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

then the income of such part of the trust shall be included in computing the net income of the grantor. (U. S. C., Title 26, Sec. 166.)

SEC. 167. INCOME FOR BENEFIT OF GRANTOR.

(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called "charitable contribution" deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section, the term "in the discretion of the grantor" means "in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question." (U. S. C., Title 26, Sec. 167.)

Treasury Regulations 86, as originally promulgated under the Revenue Act of 1934:[5]

ART. 166–1. *Trusts in the corpus of which the grantor retains an interest.*—(a) *Scope.*—Section 166 prescribes that the income, or any part of the income, of certain trusts shall be taxed, not to the trustee nor to the beneficiaries, but to the grantor because of the fact that the grantor has retained a certain interest in the property of the trust. This article deals with the taxation of such income. The term "corpus," as used in this article, means any part or the whole of the property, real or personal, constituting the subject matter of the trust.

(b) *Test of taxability to the grantor.*—The sufficiency of the grantor's retained interest in the corpus resulting in the taxation of its income to the grantor is determined by a single test, namely, whether the grantor has failed to divest himself, permanently and definitively, of every right which might by any possibility enable him once more to possess and enjoy in title the trust corpus. For the purposes of this article the sufficiency of the grantor's retained interest in the corpus is not affected by the fact that the grantor has provided that the right to cause the title to the corpus to revest in himself is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a

[5] ART. 166–1 was amended on March 7, 1936, by T. D. 4629, XV–1 Cum. Bull. 140 (1936). Art. 167–1 was amended by T. D. 4759 on September 7, 1937, 1937–2 Cum. Bull. 117, and by T. D. 4860 on September 12, 1938, 1938–2 Cum. Bull. 184. No question in the case turns upon any change in the Regulations made by these amendments.

substantial interest in the corpus or income therefrom adverse to the grantor.

If the grantor has retained any such interest in the corpus he is taxable on the income therefrom regardless of—

(1) how great or how small, how remote or how contingent the interest may be;

(2) whatever the nature of interest retained may be; whether the interest retained is vested, contingent, in reversion, or otherwise; whether conditioned on the precedent giving of notice, or on elapsing of a period of years, or on the happening of a specified event; whether taken by appointment, or by designation in the trust instrument, or merely by virtue of the grantor not conveying his whole estate in the corpus, or otherwise;

(3) the time or times at which such interest will revest the title in the grantor in possession and enjoyment, whether within or without the taxable year, whether or not the time be fixed, determinable or certain to come;

(4) whether, if the revesting in the grantor of title to the corpus is in any way dependent upon the act of anyone, that person be the grantor, or any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(5) when the trust was created.

For example, a grantor has not permanently or definitively divested himself of title to the corpus if he has placed it in trust for his son, John,

(A) for the term of three years, at the end of which time the trust might be ex-

tended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment; or

(B) for the term of a year and a day, then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not being a beneficiary, but being empowered to appoint to anyone other than herself); or

(C) for the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor has provided that the title shall or may once more revest in himself by the retention of an interest (executory or otherwise) capable of vesting title in the grantor in possession and enjoyment, in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or amendment thereof, resulting in the designation of the grantor as distributee.

Thus the inclusion within the scope of section 166 of any trust is based on the fact that the grantor has retained an interest in the corpus which once more will, or may possibly, vest the title in him in possession and enjoyment. Section 166 makes no distinction between a "revocable trust" (so-

called because of a provision in the trust instrument permitting some person at some time or in some manner to terminate the trust) and an "irrevocable trust" as such. Some "revocable trusts" are within the scope of section 166, not however by reason of the element of revocability, but because the grantor has reserved the requisite interest in the trust corpus, whether the vesting in title of such interest depends on revocation or otherwise. If no such interest has been retained, a "revocable trust" is not within the scope of section 166, even though the particular trust estate is subject to revocation by the grantor.

If the grantor strips himself permanently and definitively of every such interest in the corpus retained by him, the income of the trust realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161 and 162.

(c) *Income and deductions.*—If, as to any of the corpus, the test of taxability to the grantor is satisfied, the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such corpus as he would have been entitled to had the trust not been created.

ART. 167–1. *Trusts in the income of which the grantor retains an interest.*—(a) *Scope.*—Section 167 prescribes that the income, or any part of the income, of certain trusts shall be taxed to the grantor, not because the grantor has retained a certain interest in the *corpus* of the trust (as in section 166), but because of his retention of a certain interest in the *income* of the trust. This article deals with the taxation of such

income. The term "income," as used in this article, means any part or the whole of the income of the trust.

(b) *Test of taxability to the grantor.*— The test of the sufficiency of the grantor's retained interest in the trust income, resulting in the taxation of such income to the grantor, is whether the grantor has failed to divest himself, permanently and definitively, of every right which might, by any possibility, enable him to have the income, at some time, distributed to him, actually or constructively. Such a distribution to the grantor occurs if the income is paid to him or to another according to the grantor's direction or if, though paid to another pursuant to the terms of the trust, the benefit of the income inures to the grantor. The income so inures if it is or may be applied in satisfaction of a legal obligation of the grantor, does or may increase his net worth, does or may in any way enrich him, or does or may enable him in any way to enjoy, in substance, such income. Such a distribution also occurs if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

For the purposes of this article, the sufficiency of the grantor's retained interest in the income is not affected by the fact that the grantor has provided that the right to so effect or direct the distribution of income is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the income adverse to the grantor.

If the grantor has retained any such interest in the income, such income is taxable to the grantor regardless of—

(1) whether it may be distributed currently or accumulated for future distribution;

(2) whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(3) whether, if such distribution is in any way effected by or dependent on an exercise of discretion, the person exercising the discretion is the grantor or a person not having a substantial interest in the income adverse to the grantor, or both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(4) whether, if such distribution results in the inuring of benefits to the grantor from the application of the income in satisfaction of his legal obligation, such obligation is to pay a debt, to support dependents, to pay alimony, to furnish maintenance, and support or otherwise;

(5) the time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the elapsing of an interval of time, or on the happening of a specified event, or otherwise;

(6) when the trust was created.

Thus the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. If the grantor strips himself permanently and definitively of every such interest retained by him, the income of the trust realized after such divesting takes effect is not taxable to the grantor, but is

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taxable as provided in sections 161 and 162.

(c) *Income and deductions.*—If, as to any of the income, the test of taxability to the grantor is satisfied, such income shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such income as he would have been entitled had such income been distributable currently to him.

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